

MANAGEMENT'S DISCUSSION AND ANALYSIS

The following is a discussion and analysis of the State of Michigan's (the State's) financial performance, providing an overview of the activities for the fiscal year ended September 30, 2001. Please read it in conjunction with the transmittal letter at the front of this report and with the State's financial statements, which follow this section. Because fiscal year 2000-2001 represents the first year in which the State implemented the provisions of Governmental Accounting Standards Board (GASB) Statement No. 34, this discussion and analysis provides few comparisons with the previous year. Future reports are required to include extensive comparisons.

HIGHLIGHTS

Government-wide:

- The assets of the State exceeded its liabilities at the close of the fiscal year by \$22.5 billion (reported as *net assets*), a decrease of \$74.2 million from the previous year. Component units reported net assets of \$4.3 billion, an increase of \$219.0 million from the previous year.

Fund Level:

- As of the close of the fiscal year, the State's governmental funds reported combined ending fund balances of \$5.8 billion, with \$2.6 billion reported as *unreserved fund balance* and the remaining amount of \$3.2 billion reserved for specific purposes, such as education and transportation. At the end of the fiscal year, unreserved fund balance for the General Fund was \$28.1 million.
- The proprietary funds reported net assets at year-end of \$3.2 billion, a decrease of \$159.3 million during the year.

Long-term Debt:

- The State's total debt rose during the fiscal year to \$5.2 billion, an increase of \$956.4 million (or 22.6%), which represents the net difference between new issuances, and payments and refundings of outstanding debt. During the year the State issued bonds (\$1.5 billion), notes (\$400 million), and commercial paper (\$653.8 million).

More detailed information regarding these activities and funds begins on page 7.

OVERVIEW OF THE FINANCIAL STATEMENTS

This discussion and analysis is an introduction to the State's basic financial statements, which comprise three components: 1) government-wide financial statements, 2) fund financial statements, and 3) notes to the financial statements. This report also contains other supplementary information in addition to the basic financial statements.

For the first time, this report includes government-wide financial statements as required by GASB Statement No. 34.

Government-wide Statements (Reporting the State as a Whole)

The Statement of Net Assets and the Statement of Activities are two financial statements that report information about the State, as a whole, and about its activities that should help answer this question: Is the State, as a whole, better off or worse off as a result of this year's activities? These statements include all non-fiduciary assets and liabilities using the accrual basis of accounting. The current year's revenues and expenses are taken into account regardless of when cash is received or paid.

The Statement of Net Assets (pages 14 and 15) presents all of the State's assets and liabilities, with the difference between the two reported as "net assets". Over time, increases and decreases in net assets measure whether the State's financial position is improving or deteriorating.

The Statement of Activities (pages 16 and 17) presents information showing how the State's net assets changed during the most recent fiscal year. All changes in net assets are reported as soon as the underlying events giving rise to the change occur, regardless of the timing of related cash flows. Therefore, revenues and expenses are reported in these statements for some items that will only result in cash flows in future fiscal periods (e.g. uncollected taxes and earned but unused vacation leave).

Both statements report three activities:

- *Governmental Activities* – Most of the State's basic services are reported under this category. Taxes and intergovernmental revenues generally fund these services. The Legislature, the Judiciary, and the general operations of the Executive departments fall within the governmental activities.

- *Business-type Activities* – The State charges fees to customers to help it cover all or most of the cost of certain services it provides. Lottery tickets, liquor purchases, and the State's unemployment compensation services are examples of business-type activities.
- *Discretely Presented Component Units* – Component units are legally separate organizations for which the elected officials of the primary government are financially accountable. The State has 12 authorities and 10 universities that are reported as discretely presented component units of the State.

This report includes two schedules (pages 21 and 23) that reconcile the amounts reported on the governmental fund financial statements (modified accrual accounting) with governmental activities (accrual accounting) on the appropriate government-wide statements. The following summarizes the impact of transitioning from modified accrual to accrual accounting:

- Capital assets used in governmental activities are not reported on governmental fund statements.
- Certain tax revenues that are earned, but not available, are reported as governmental activities, but are reported as deferred revenue on the governmental fund statements.
- Other long-term assets that are not available to pay for current period expenditures are deferred in governmental fund statements, but not deferred on the government-wide statements.
- Internal service funds are reported as governmental activities, but reported as proprietary funds in the fund financial statements.
- Certain pension trust funds have been funded in excess of their annual required contribution. These assets are recorded only in the government-wide statements.
- Deferred issue costs are capitalized and amortized as governmental activities, but reported as expenditures in the governmental fund statements.
- Unless due and payable, long-term liabilities, such as capital lease obligations, compensated absences, litigation, bonds and notes payable, and others only appear as liabilities in the government-wide statements.
- Capital outlay spending results in capital assets on the government-wide statements, but are reported as expenditures on the governmental fund statements.
- Bond and note proceeds result in liabilities on the government-wide statements, but are recorded as other financing sources on the governmental fund statements.
- Certain other outflows represent either increases or decreases in liabilities on the government-wide statements, but are reported as expenditures on the governmental fund statements.

The Notes to the Basic Financial Statements provide additional information that is essential to a full understanding of the data provided in the government-wide and fund financial statements. The notes can be found beginning on page 41 of this report.

Fund Financial Statements (Reporting the State's Major Funds)

The fund financial statements begin on page 20 and provide detailed information about the major individual funds. A fund is a fiscal and accounting entity with a self-balancing set of accounts that the State uses to keep track of specific sources of funding and spending for a particular purpose. In addition to the major funds, page 96 begins the individual fund data for the non-major funds. The State's funds are divided into three categories – governmental, proprietary, and fiduciary – and use different accounting approaches.

- *Governmental funds* -- Most of the State's basic services are reported in the governmental funds, which focus on how money flows into and out of those funds and the balances left at year-end that are available for future spending. The governmental fund financial statements provide a detailed short-term view of the State's general government operations and the basic services it provides. Governmental fund information helps determine whether there are more or fewer financial resources that can be spent in the near future to finance the State's programs. These funds are reported using *modified accrual* accounting, which measures cash and all other financial assets that can readily be converted to cash. Governmental funds include the General Fund and special revenue, capital project, debt service, and permanent funds.
- *Proprietary funds* -- When the State charges customers for the services it provides, whether to outside customers or to other agencies within the State, these services are generally reported in proprietary funds. Proprietary funds (enterprise and internal service) utilize accrual accounting; the same method used by private sector businesses. Enterprise funds report

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activities that provide supplies and services to the general public. An example is the State Lottery Fund. Internal service funds report activities that provide supplies and services for the State's other programs and activities - such as the State's Vehicle and Travel Services. Internal service funds are reported as governmental activities on the government-wide statements.

- *Fiduciary funds* -- The State acts as a trustee or fiduciary, for its employee pension plans. It is also responsible for other assets that, because of a trust arrangement, can be used only for the trust beneficiaries. The State's fiduciary activities are reported in separate Statements of Fiduciary Net Assets and Changes in Fiduciary Net Assets beginning on page 32. These funds, which include pension (and other employee benefit), private-purpose, and agency funds, are reported using accrual accounting. The government-wide statements exclude fiduciary fund activities and balances because these assets are restricted in purpose and do not represent discretionary assets of the State to finance its operations.

Additional Required Supplementary Information

Following the basic financial statements is additional Required Supplementary Information that further explains and supports the information in the financial statements. The Required Supplementary Information includes budgetary comparison schedules reconciling the statutory and generally accepted account principles (GAAP) fund balances at fiscal year-end, and condition and maintenance data regarding certain portions of the State's infrastructure.

Other Supplementary Information

Other supplementary information includes combining financial statements for non-major governmental, proprietary, and fiduciary funds, and non-major discretely presented component units. These funds are added together, by fund type, and presented in single columns in the basic financial statements, but are not reported individually, as with major funds, on the governmental fund financial statements.

FINANCIAL ANALYSIS OF THE GOVERNMENT AS A WHOLE

The State's combined net assets decreased \$74.2 million over the course of this fiscal year's operations. The net assets of the governmental activities increased \$135.4 million or .7% and business-type activities had a decrease of \$209.5 million or 6.3%.

Net Assets as of September 30, 2001 (in millions of dollars)			
	Governmental Activities	Business-type Activities	Total Primary Government
Current and other non-current assets	\$ 12,420.6	\$ 4,219.9	\$ 16,640.4
Capital assets	17,750.5	.3	17,750.8
Total assets	30,171.1	4,220.1	34,391.2
Long-term liabilities	6,606.5	660.3	7,266.8
Other liabilities	4,180.8	431.8	4,612.5
Total liabilities	10,787.3	1,092.0	11,879.3
Net assets:			
Invested in capital assets, net of related debt	15,129.8	.3	15,130.1
Restricted	2,849.2	3,121.4	5,970.6
Unrestricted	1,404.8	6.4	1,411.2
Total net assets	\$ 19,383.8	\$ 3,128.1	\$ 22,511.9

The largest component (67.2%) of the State's net assets reflects its investment in capital assets (e.g. land, buildings, equipment, infrastructure, and others), less any related debt outstanding that was needed to acquire or construct the assets. Restricted net assets are the next largest component, comprising 26.5%. These represent resources that are subject to external restrictions, constitutional provisions, or enabling legislation on how they can be used. The remaining portion, unrestricted net assets, may be used at the State's discretion, but often have limitations on use based on State statutes.

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The following condensed financial information was derived from the government-wide Statement of Activities and reflects how the State's net assets changed during the fiscal year:

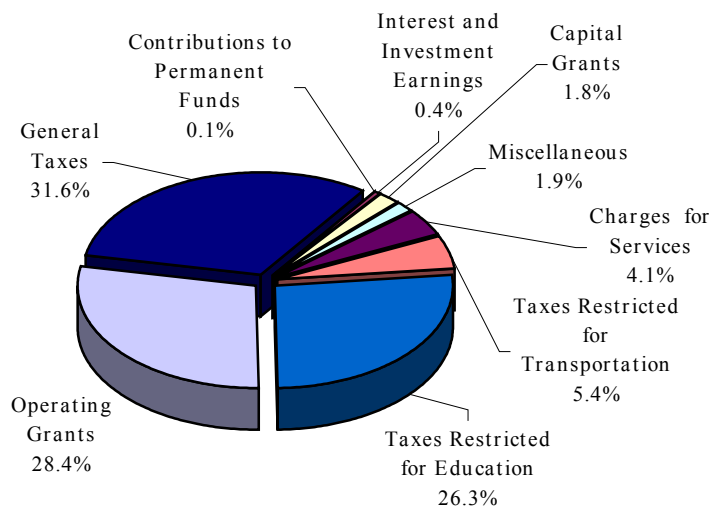
Changes in Net Assets for Fiscal Year Ending September 30, 2001 (in millions of dollars)

	Governmental Activities	Business-type Activities	Total Primary Government
Revenues			
Program revenues			
Charges for services	\$ 1,496.9	\$ 3,297.9	\$ 4,794.8
Operating grants	10,255.3	313.6	10,569.0
Capital grants	667.4	-	667.4
General revenues			
General taxes	11,425.7	10.4	11,436.2
Taxes restricted for educational purposes	9,500.3	-	9,500.3
Taxes restricted for transportation purposes	1,936.3	-	1,936.3
Interest and investment earnings	159.2	4.2	163.4
Miscellaneous	669.0	-	669.0
Total revenues	<u>36,110.1</u>	<u>3,626.2</u>	<u>39,736.3</u>
Expenses			
General government	1,735.2	-	1,735.2
Education	14,109.6	-	14,109.6
Family independence services	3,627.8	-	3,627.8
Public safety and corrections	2,098.6	-	2,098.6
Conservation, recreation, and agriculture	682.9	-	682.9
Labor, commerce, and regulatory	884.1	-	884.1
Health services	8,536.0	-	8,536.0
Transportation	2,766.7	-	2,766.7
Tax expenditures	532.8	-	532.8
Intergovernmental – revenue sharing	1,555.8	-	1,555.8
Interest on long-term debt	221.3	-	221.3
Liquor Purchase Revolving Fund	-	479.4	479.4
State Lottery Fund	-	1,132.8	1,132.8
Michigan Unemployment Compensation Funds	-	1,485.9	1,485.9
Total expenses	<u>36,750.8</u>	<u>3,098.1</u>	<u>39,848.9</u>
Excess (deficiency) Before Contributions and Transfers	(640.7)	528.1	(112.6)
Contributions to permanent fund principal	38.4	-	38.4
Transfers	737.6	(737.6)	-
Increase (decrease) in net assets	135.4	(209.5)	(74.2)
Net assets – beginning – restated	19,248.4	3,337.6	22,586.0
Net assets – ending	<u>\$ 19,383.8</u>	<u>\$ 3,128.1</u>	<u>\$ 22,511.8</u>

Governmental Activities:

The following chart depicts revenues of the governmental activities for the fiscal year:

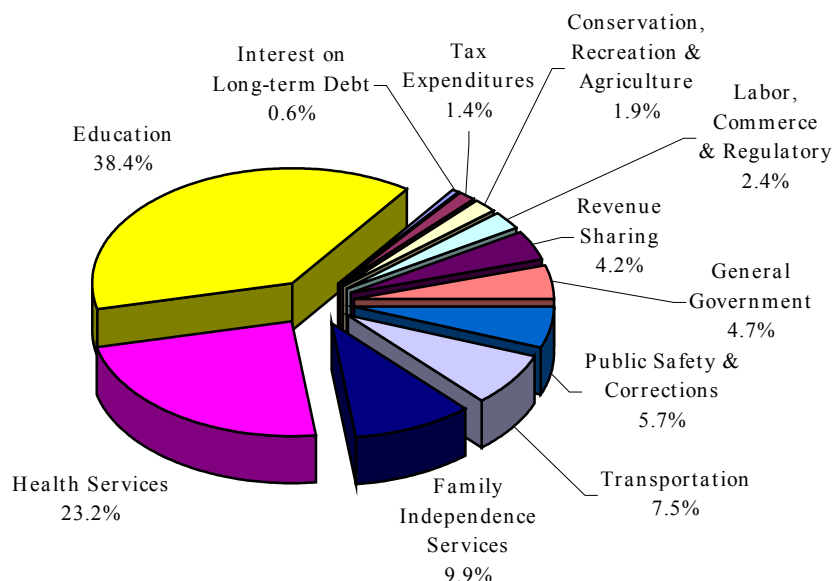
**Revenues - Governmental Activities
Fiscal Year Ending September 30, 2001**



Revenues for the State's governmental activities are likely to decrease in the coming years as the personal income and single business tax rates will experience gradual declines. Starting on January 1, 1999, the single business tax rate has been reduced by .1 percent each January 1 if the Budget Stabilization Fund has a fund balance greater than \$250 million. Beginning on January 1, 2000, the personal income tax is being reduced each year until the rate reaches 3.9%. There were no significant structural changes in the State's sales taxes during fiscal year 2000-2001. Decreases in tax revenues during the fiscal year resulted from these tax rollbacks, in addition to the slowdown in the economy.

The following chart depicts expenses of the governmental activities for the fiscal year:

**Expenses - Governmental Activities
Fiscal Year Ending September 30, 2001**



Business-type Activities

Net assets of the business-type activities decreased by \$209.5 million during the fiscal year. Factors contributing to these results included:

- The State Lottery Fund's net assets increased by \$44.8 million for the fiscal year, primarily from the increase in the market value of investments.
- Due to increasing unemployment in the State, the Michigan Unemployment Compensation Funds' payment of these benefits increased from \$905.9 million in fiscal year 1999-2000 to \$1.5 billion during fiscal year 2000-2001. However the impact on net assets was about half that amount, \$254.3 million, because of increases in operating revenues during the year.

FINANCIAL ANALYSIS OF THE STATE'S FUNDS

As the State completed the year, its governmental funds reported fund balances of \$5.8 billion. Of this total amount, \$2.6 billion, or 43.9% constitutes unreserved fund balance, which is available for appropriation for the general purposes of the funds. The School Aid Fund, (\$694.8 million), the Budget Stabilization Fund (\$994.2 million), and transportation-related funds (\$539.4 million) comprise a significant portion of the unreserved fund balance. The remainder of fund balance is reserved and is not available for new spending because it has already been dedicated for various commitments, such as capital outlay projects.

General Fund

The General Fund is the chief operating fund of the State. At the end of current fiscal year 2000-2001, unreserved fund balance of the General Fund was \$28.1 million and reserved fund balance was \$1.9 billion. Total fund balance diminished slightly during the fiscal year (\$192.8 million), primarily as a result of lower tax collections and slowing of the economy. By the end of fiscal year 2000-2001, net General Fund revenues had declined 8.1 percent from the prior year.

General Fund Budgetary Highlights:

Changes in the State's projected revenue mirrored the national economic condition. In May 2001, it became apparent that state revenues were declining and fiscal year 2000-2001 budgets were adjusted downward to reflect the softening revenues.

As a result, the original budget was amended by various supplemental appropriations and appropriation revisions. The following summarizes the differences between the original and final budget amounts:

- General purpose tax revenues of \$8.7 billion were significantly less than the estimated \$9.4 billion.
- Restricted revenue inflows of \$12.6 billion were slightly greater than the estimated \$12.5 billion.
- Funding shifts for several major construction projects from the General Fund to the State Building Authority resulted in a decrease of \$211.2 million, of which \$195.7 million related to appropriation revisions in fiscal year 2000-2001.
- Agencies controlled spending in an effort to create budgetary savings of almost \$24.4 million.
- The Budget Stabilization Fund transferred \$270.0 million to the General Fund to balance the budget.

Differences between the final budget and actual spending result from spending authority lapses of \$89.6 million, over-expended appropriations of \$31.9 million, and restricted revenue authorized but not spent of \$9.3 million.

Overall, there were no net overexpenditures by General Fund departments. There were, however, the following line-item overexpenditures of State funds incurred during the year:

Community Health	\$31.3 million
Career Development	\$.6 million

Although it is anticipated that the General Fund will experience reduced revenues in the next fiscal year, corresponding reductions in spending and other measures will help ensure that the fund balance remains positive.

School Aid Fund

Fund balance at September 30, 2001 totaled \$704.1 million, a decrease of \$281.5 million from the prior year. Although revenues increased by \$264.4 million, expenditures to school districts and other costs increased by nearly \$900 million and transfers to the fund decreased by \$66.4 million.

Counter-cyclical Budget and Economic Stabilization Fund

Fund balance at September 30, 2001 decreased to \$994.2 million, from \$1.3 billion the previous year. The downturn in the economy required an increase in transfers from the fund to assist the State in balancing its budget. During fiscal year 2001-2002, the State anticipates that transfers from the fund will significantly reduce fund balance.

CAPITAL ASSETS AND DEBT ADMINISTRATION

Capital Assets: At the end of the fiscal year 2000-2001, the State had invested \$17.8 billion, net of accumulated depreciation, in a broad range of capital assets (see the table below). Depreciation charges for this fiscal year totaled \$199.7 million.

Capital Assets as of September 30, 2001
(net of depreciation, in millions of dollars)

	Governmental Activities	Business-type Activities	Total Primary Government
Land	\$ 3,093.3	\$ -	\$ 3,093.3
Land improvements	56.2	-	56.2
Buildings and improvements	1,714.5	-	1,714.5
Equipment	193.1	.3	193.4
Infrastructure	11,810.4	-	11,810.4
Other	20.7	-	20.7
Subtotal	16,888.2	.3	16,888.5
Construction in progress	862.3	-	862.3
Total	\$ 17,750.5	\$.3	\$ 17,750.8

Although the most significant change in accounting for capital assets during the year resulted from the inclusion of infrastructure assets, the State also purchased the Grand Tower building, which houses the Family Independence Agency, for approximately \$40 million and completed construction on a variety of projects at correctional facilities that totaled approximately \$100 million.

As allowed by GASB Statement No. 34, the State has adopted an alternative process for recording depreciation expense on selected infrastructure assets. Under this alternative method, referred to as the modified approach, the State expenses certain maintenance and preservation costs and does not report depreciation expense. Assets accounted for under the modified approach include approximately 27,300 lane miles of roads and approximately 5,700 bridges that the State is responsible to maintain.

The State has consistently improved the assessed condition of roads over the past five years. The State's goal is to have no more than 30% of roads in "poor" or "very poor" condition. The most recent condition assessment, completed for calendar year 2000, indicated that 22% of roads were considered poor or very poor.

The State's bridges have assessed conditions which are better than the established benchmarks, although the most recent assessment (2000) indicated that the condition of the bridges had deteriorated slightly from 1999.

The State's fiscal year 2001-2002 capital outlay budget projects spending \$486.2 million for new projects at Michigan colleges and universities, and special maintenance projects at various state agency buildings, in addition to \$329.1 million of unspent capital outlay authorizations that existed at September 30, 2001. More detailed information about the State's capital assets is presented in Note 10 to the financial statements.

Long-term Debt: The State, along with the State Building Authority (SBA), a component unit of the State, are empowered by law to authorize, issue, and sell debt obligations. General obligation bonds, issued by the State, are backed by the full faith and credit of the State. The State also issues revenue dedicated bonded debt, whose payment for principal and interest comes solely out of funds that receive legally restricted revenues. SBA issues debt that is not backed by the State's full faith and credit. SBA's bonds generate revenue to finance the construction of facilities used by the State and universities. Revenues derived from leases on the facilities fund the debt service requirements. More detailed information regarding the State's long-term obligations is presented in Note 14 to the financial statements.

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Outstanding Bonded Debt as of September 30, 2001 (in millions of dollars)

	<u>Governmental Activities</u>	<u>Business-type Activities</u>	<u>Total Primary Government</u>
General obligation bonds (backed by the State)	\$ 1,031.8	\$ -	\$ 1,031.8
Revenue bonds and notes (backed by specific tax and fee revenues)	3,433.3	-	3,433.3
Total	<u>\$ 4,465.1</u>	<u>\$ -</u>	<u>\$ 4,465.1</u>

During fiscal year 2000-2001, the State issued general obligation debt totaling \$324.6 million, including \$183.3 million to pay off amounts outstanding on previously issued bonds that carried higher interest costs, \$60.0 million of bonds to fund conservation and recreation projects, and \$81.3 million of bonds to provide funds to loan to school districts.

Bond Ratings

The State's general obligations are rated Aaa by Moody's and AAA by Standard & Poors.

Limitations on Debt

The State Constitution authorizes general obligation long-term borrowing, with approval of the Legislature and a majority of the voters, and general obligation short-term notes, of which the principal may not exceed 15% of undedicated revenues received in the preceding year. No short-term borrowing occurred in fiscal year 2000-2001.

ECONOMIC CONDITION AND OUTLOOK

Downturns in the U.S. economy that began in March 2001 had a similar impact on the State. Michigan's unemployment rate averaged 5.0% in 2001, up from 3.6% the year before. In May 2001 it became apparent that State revenues were declining and the budget for the 2000-2001 and 2001-2002 fiscal years were adjusted to reflect the softening revenues.

For fiscal year 2001-2002, spending reductions of nearly \$460 million have been approved, in addition to the more than \$210 million in spending reductions contained within the original fiscal 2001-2002 budget. As previously mentioned, the Budget Stabilization Fund will be utilized to soften the impact of the slowing economy.

CONTACTING THE STATE'S OFFICE OF FINANCIAL MANAGEMENT

This financial report is designed to provide our citizens, taxpayers, customers, investors, and creditors with a general overview of the State's finances and to demonstrate the State's accountability for the money it receives. If you have any questions about this report or need additional financial information, contact the Office of the State Budget, Office of Financial Management, Financial Reporting Section at (517) 373-3029.

The State's component units issue their own separately issued audited financial statements. These statements may be obtained by directly contacting the component unit. To obtain their phone numbers, you may contact the Office of Financial Management at (517) 373-3029.